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AZ CORP COMMISSION  
DOCUMENT CONTROL

**BEFORE THE ARIZONA CORPORATION COMMISSION**

IN THE MATTER OF THE APPLICATION  
OF GOLD CANYON SEWER COMPANY,  
AN ARIZONA CORPORATION, FOR A  
DETERMINATION OF THE FAIR VALUE  
OF ITS UTILITY PLANT AND PROPERTY  
AND FOR INCREASES IN ITS RATES  
AND CHARGES FOR UTILITY SERVICE  
BASED THEREON.

DOCKET NO: SW-02519A-06-0015

**NOTICE OF FILING WITNESS  
SUMMARIES**

Gold Canyon Sewer Company ("Gold Canyon") hereby submits this Notice of Filing in the above-entitled matter. Attached hereto as Attachment 1 is the summary of the pre-filed testimony of Charles Anthony Hernandez. Attached hereto as Attachment 2 is the summary of the pre-filed testimony of Greg Sorensen. Attached hereto as Attachment 3 is the summary of the pre-filed testimony of Thomas J. Bourassa.

DATED this 30th day of October, 2006.

FENNEMORE CRAIG, P.C.

Arizona Corporation Commission  
**DOCKETED**

**OCT 30 2006**

DOCKETED BY

By

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1 ORIGINAL and thirteen (13) copies of the  
2 foregoing were delivered this  
3 30th day of October, 2006, to:

4 Docket Control  
5 Arizona Corporation Commission  
6 1200 W. Washington St.  
7 Phoenix, AZ 85007

8 A copy of the foregoing was hand-delivered  
9 this 30th day of October, 2006, to:

10 Chairman Jeff Hatch-Miller  
11 Arizona Corporation Commission  
12 1200 W. Washington Street  
13 Phoenix, AZ 85007

14 Commissioner William A. Mundell  
15 Arizona Corporation Commission  
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15 A copy of the foregoing was mailed  
16 this 30th day of October, 2006, to:

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26

# **Attachment 1**

## **GOLD CANYON SEWER COMPANY**

**Docket No. SW-02519A-06-0015**

### **Summary of Testimony of Charles Anthony Hernandez**

Mr. Hernandez is employed by Algonquin Water Services as Regional Operations Manager. He manages and directs the overall operation and maintenance of both the water and wastewater operations on behalf of AWS, and is responsible on a day-to-day basis to ensure the safe, efficient operation and maintenance of the plants and proper monitoring and reporting of all operations. Mr. Hernandez also lives in Gold Canyon and his office is located in Gold Canyon Sewer Company's ("GCSC" or "Company") wastewater treatment plant. Mr. Hernandez filed rebuttal and rejoinder testimony and in this rate proceeding. He will also be adopting the direct testimony of Michael Weber who is no longer with Algonquin.

The Company has made substantial investment in plant improvements including the recent renovation and expansion of the wastewater treatment facility with a price tag in excess of \$11 million. The recent improvements included numerous odor and sound control features as well as refurbishment of existing facilities to improve performance and increase capacity to 1.9 million gallons per day, the maximum permitted capacity for GCSC's treatment facility. These improvements have virtually eliminated sound and odors from normal day-to-day operations, as reflected in the inspections conducted of the facilities by ADEQ and ACC engineering staff.

RUCO's claim of excess capacity is in error. GCSC's decision to bring the plant to its maximum permitted capacity was reasonable and prudent. GCSC had experienced peak flows in excess of the capacity available prior to the renovation and expansion and additional capacity was needed to ensure that the Company has sufficient treatment capacity to meet peak flows, especially in the winter months when the Company's customer base expands to its maximum. Peak flows are expected to exceed 1.5 million gallons per day in 2007, the minimum the Company could have expanded from its previous capacity of 1 million gallons per day. Regulatory agencies like ADEQ expect sewer providers to ensure that capacity is available before it is needed. In addition, the Company realized a substantial savings on the cost of capacity by completing the expansion of the plant to its maximum permitted capacity as part of the recent renovation and expansion. Moreover, contrary to RUCO's claim, the odor and sound control features are not operating at less than full capacity when the plant is not treating flows equal to its maximum capacity. Rather, such features do not operate differently depending on flow levels.

Finally, GCSC is currently in full compliance with ADEQ requirements. Prior deficiencies related to record keeping for effluent reuse by golf courses receiving deliveries of the Company's effluent have been resolved. The Company also has resolved deficiencies related to nitrate levels at the point of compliance. Although the background levels of nitrate in the water supply averages 70 mg/l, the permit for the Company's facility set an alert level of 8 mg/l and GCSC was averaging 9 mg/l. Although ADEQ has since found this compliance issue resolved, the Company continues to actively monitor the nitrate levels and is working with ADEQ to alter the permit alert level to a more appropriate level. At no time did either compliance matter threaten the public health or safety.

# **Attachment 2**

## **GOLD CANYON SEWER COMPANY**

**Docket No. SW-02519A-06-0015**

### **Summary of Testimony of Greg Sorensen**

Mr. Sorensen is employed by Algonquin Water Services as Vice President of Finance. He oversees the accounting, customer service, and administration duties for AWS, which manages and operates 15 utilities in Arizona, Texas, Missouri, and Illinois. This includes responsibility for the integrity of the financial records, monthly and annual financial reporting requirements, budgeting, rate case planning and oversight, directing customer service activities, and setting policies and procedures. Mr. Sorensen filed rejoinder testimony in this case, which testimony was filed in response to Staff's adjustments to remove more than \$67,000 from rate base and more than \$78,000 from operating expenses because Staff has concluded that an affiliate can never earn a profit on services provided to a public service corporation.

Gold Canyon Sewer Company ("GCSC" or "Company") affiliates provide operations personnel, facility inspectors, engineers, project management, accounting, customer service, general management and administrative services, including executive oversight, strategic planning, legal, human resources, finance and accounting. Affiliates also provide professional services in the areas of health and safety and environmental compliance. This is the most cost effective way to operate several water and sewer utility providers in different parts of the country while providing the broadest range of available services to the benefit of GCSC and its ratepayers.

While some profit is expected to be recovered on many of the services provided to GCSC by affiliates, profit is not guaranteed, as claimed by Staff. The amount of profit earned, if any, varies from year to year depending on the costs that are incurred and the revenues generated by the affiliates providing such services. This means that capital invested by the shareholders of the affiliated entities providing services to GCSC is at risk. The affiliates are businesses, not charities and the purpose of a business is to make a return on an investment, in other words, a profit. Mere cost recovery is not the goal of a business. Thus, Staff's position that these affiliated entities should work for nothing is unreasonable. This is particularly true given Staff's position that the same costs would have been recoverable, including profit, if incurred by GCSC transacting business with an unaffiliated third-party. In such case, Staff would have verified that the cost was actually incurred to serve customers and the full expense would have been included in operating expenses or rate base, as appropriate. Here, Staff wants to strip the profit out of a model that results in great benefits at reasonable cost by discriminating against the affiliates. It is a windfall for the ratepayer.

# **Attachment 3**



## **GOLD CANYON SEWER COMPANY**

**Docket No. SW-02519A-06-0015**

### **Summary of Testimony of Thomas J. Bourassa**

Mr. Bourassa is a Certified Public Accountant providing various accounting and consulting services to businesses, including utilities. He has prepared or has assisted in the preparation of rate applications for a number of Arizona water and wastewater utilities. In this rate proceeding, Mr. Bourassa was responsible for preparing, and is sponsoring, Schedules A through H of the standard filing requirements for Class B water utilities, as set forth in A.A.C. R14-2-103, and for the overall development of the revenue requirement for Gold Canyon Sewer Company ("GCSC" or "Company") in this case.

Mr. Bourassa filed direct, rebuttal and rejoinder testimony, which generally addresses the following aspects of GCSC's rate application:

- (1) Revenue Requirement.
- (2) Rate Base (original cost, reconstruction cost and fair value).
- (3) Revenues and Expenses (including depreciation and taxes).
- (4) Capital Structure and Cost of Capital
- (5) Rates and Rate Design.

A summary of the key issues addressed in Mr. Bourassa's pre-filed testimony follows:

#### **I. REVENUE REQUIREMENT**

The parties' respective revenue requirements as of the rejoinder stage of this proceeding are as follows:

	<u>Revenue Req.</u>	<u>Revenue Incr.</u>	<u>% Increase</u>
Staff - Surrebuttal	\$4,277,120	\$1,780,740	71.33%
RUCO - Surrebuttal <sup>1</sup>	\$3,505,335	\$1,008,955	40.42%
Company Rejoinder	\$4,794,763	\$2,298,383	92.07%

The Company proposes its original cost rate base ("OCRB") be used as its fair value rate base ("FVRB") to determine the revenue requirement.

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<sup>1</sup> Per RUCO Revised Schedules, September 14, 2006.

## **II. RATE BASE**

### **A. Overview of Rate Base**

The parties' respective rate bases as of the rejoinder stage of this proceeding are as follows:

	<u>OCRB</u>	<u>FVRB</u>
Staff - Surrebuttal	\$ 15,725,787	\$ 15,725,787
RUCO - Surrebuttal	\$ 13,728,921	\$ 13,728,921
Company - Rejoinder	\$ 15,742,719	\$ 15,742,719

### **B. Plant Retirements**

GCSC, Staff and RUCO agree on the retirements of test year plant related to water treatment and disposal equipment to be removed from rate base and all parties agree to a cost of \$272,191. GCSC, Staff, and RUCO also agree to remove associated accumulated depreciation from rate base.

### **C. Deferred Income Taxes**

GCSC accepted Staff's proposal to include a deferred income tax liability equal to approximately \$254,681 in rate base. RUCO has also agreed to include deferred income taxes in rate base, however, in its revised schedules dated September 14, 2006, RUCO has proposed a deferred tax asset which results from RUCO's proposed "excess capacity" adjustment to rate base. It should be noted that RUCO's adjusted deferred tax balance of \$411,931 as shown in its revised rate base schedule SURR RLM-2, page 1, does not agree with its deferred tax computation of \$666,612, as shown on revised schedule SURR RLM-2, page 2.

### **D. RUCO's Adjustment for Excess Capacity**

The Company's disagrees with RUCO's capacity adjustment reducing rate base by \$2,789,016. The Company renovated and expanded its wastewater treatment plant. The Company should not be punished for proactively and prudently investing capital to meet system needs, especially when the actions by the Company resulted in significant cost savings. The entire wastewater treatment system is used and useful and the full cost of the recent renovation and expansion should be included in rate base.

### **E. Affiliated Transactions**

The Company disagrees with Staff's proposal to eliminate \$67,499 from rate base, the portion of the cost of plant additions representing profit earned by affiliated entities providing services necessary to build used and useful plant. This amount was primarily incurred for engineering and project management services at hourly rates at or below known third-party hourly rates. This means that GCSC paid no more and likely far less for these services than it would for equivalent services from non-affiliates. Nevertheless, Staff failed to conduct any sort

of prudency review, instead, Staff has adopted a rule that affiliates are not entitled to a profit on services they provide to the Company under any circumstances.

**F. Working Capital**

The Company is in agreement with Staff's recommended zero working capital allowance.

**G. Miscellaneous Rate Base Issues in Dispute**

Both Staff and RUCO have proposed certain operating expenses incurred during the test year be capitalized. The Company agrees with RUCO's proposed amount for \$7,045 rather than Staff's proposed \$13,809. The issue surrounds two invoices which the Company and RUCO agree included only 60% of costs for capital related services whereas Staff asserts the services were for 100% capital related.

**III. REVENUES AND EXPENSES**

**A. Overview of Income Statement**

Some of the Company's more notable adjustments to the test year in order to normalize revenues and expenses and to take into account known and measurable changes include :

- (1) Annualizing revenues to the year end level of test year customers.
- (2) Annualizing depreciation expense using account specific depreciation rates based on Staff's typical and customary rates rather than the previously approved 2.5% composite rate;
- (3) Increasing property and income taxes to reflect proposed revenues;
- (3) Inclusion of rate case expense amortized over 4 years;
- (4) Increasing "lease" expense for the Scottsdale Capacity which reflects the annual debt service on the debt funding the capacity plus a gross-up for income taxes on the non-deductible principle portion of the debt service;
- (5) Annualizing purchased power expense.

A number of additional adjustments were made at the rebuttal and rejoinder stages based on the positions of the other parties. Notable adjustments include:

- (1) Removal of capitalized expenses;
- (2) Removal of late fees;
- (3) Removal of non-recurring equipment rental and effluent hauling expense;
- (4) Removal of other expenses including, CC&N expenses, non-test year expenses, and fish restocking costs;
- (5) Removal of ACC assessments.

With these various adjustments based on known and measurable changes, the Company's proposed adjusted test year level of operating expenses is equal to \$2,254,628. Staff and

RUCO's recommended operating expenses are lower and there remain a number of income statement issues in dispute between the parties.

**B. Affiliated Transactions**

Staff's elimination of \$78,607 of so-called "affiliate profit" from operating expenses is consistent with Staff's recommendation for similar adjustments to rate base discussed above. Staff made little to no effort to determine whether the total cost was reasonable, ignoring demonstrated costs savings to the Company and ratepayers due to economies of scale achieved under the business model employed. Staff's position that the total cost would be reasonable if identical services were provided by non-affiliates reflects Staff's discriminatory treatment of affiliates and is not proper ratemaking.

**C. Central Office Overhead**

The Company opposes Staff's proposal to remove over \$34,000 of the \$48,000 of central office overhead costs allocated to the Company. Staff's assertion that "these costs are not needed" is erroneous and unsupported by credible evidence. Under any reasoned ratemaking analysis, the central office overhead costs are shown to be necessary and at a cost lower than such costs would be expected to be incurred outside the business model employed. Not only are the overhead costs based on actual costs, but all of the central office costs are legitimately incurred and are a benefit to the Company and rate payers.

**D. Property Taxes**

The Company and Staff agree on the method to be used to determine property taxes, which methodology uses proposed revenues and follows the Arizona Department of Revenue property tax calculation. Both the Company and Staff utilize one year of proposed revenues and two years of adjusted test year revenue in the computation. The difference between the Company and Staff on the recommended property tax expense level is due to the different revenue levels recommended. RUCO, in contrast, continues to offer the same historical revenue approach, using the test year and the two prior years, that has repeatedly been rejected by the Commission as unfair and short-sighted. *See, e.g., Rio Rico Utilities*, Decision No. 67279 at 8; *Arizona Water Company*, Decision No. 64282 at 12-13; *Bella Vista Water Company*, Decision No. 65350 at 16.

**E. Rate Case Expense**

As of its rejoinder, GCSC sought to recover \$160,000 amortized over 4 years (\$40,000 annually), an amount that will be adjusted at the hearing due to the further incurrence of fees for an odor expert in response to customer complaints lodged in response to the request for new rates. GCSC has incurred far more than the amount it will ask to recover through rates, nevertheless, RUCO seeks to reduce rate case expense to \$70,000 based on unsupported claims that significant amounts of rate case expense are questionable or excessive and comparison to cases that bear little resemblance to this rate proceeding. .

## **F. Capitalized Expenses**

GCSC agrees with RUCO to remove expenses which should have been capitalized to plant-in-service totaling \$7,045. Staff's proposes to remove expenses totaling \$13,809. The difference between the parties consists of two engineering invoices which the Company and RUCO agree to capitalize 60% of the cost as only this portion relates to capital related services. Staff proposes to capitalize 100% of the cost of these two invoices.

## **G. Miscellaneous Income Statement Issues in Dispute**

The Company has found an error in Staff's computation of depreciation expense which has resulted in an understatement of expense by \$40,500. This error is the result of Staff exclusion of \$810,000 of plant included in rate base, by not included in its depreciation calculation.

## **IV. COST OF CAPITAL**

GCSC's updated cost of capital analysis indicated that a return on equity ("ROE") of 10.5% is appropriate, within the ranges produced by the analysis and conservative when GCSC's extremely small size and other business risks are considered. GCSC's cost of equity estimates were based on the discounted cash flow ("DCF") model. The risk premium analysis, comparable earnings analysis (the current, authorized, and projected equity returns for the sample group of publicly traded utilities), and the economic conditions expected to prevail during the period in which new rates will be in effect, serve as a check of the reasonableness of the DCF results and ensure meaningful and realistic results. As an additional check on the reasonableness of the Company's cost of capital recommendations, the Company prepared a separate market based bond risk premium analysis using an annual time series on bond returns compared returns for the water utility sample. This additional analysis confirms the Company's recommended cost of capital is not only reasonable, but very conservative.

There are a number of deficiencies in the methods used by Staff and RUCO, deficiencies that result in a downward bias, reducing the cost of equity produced by their models. The Staff historical dividend per share ("DPS") and earnings per share ("EPS") growth rates in the DCF model produce indicated costs of equity of below the cost of investment grade bonds (Baa). Staff's current market risk premium Capital Asset Pricing Model is extremely unstable and should not be used. Similarly, RUCO's cost of capital witness relies analyst's estimates of growth but then applies his own conclusions about those estimates, with downward adjustments to set internal growth estimates for the DCF analysis. RUCO's methods also downwardly adjusts external growth estimates by assuming that the market-to-book ratio should move toward 1.0, which further skews the DCF results downward.

There are also problems with Staff and RUCO's CAPM analyses. An inherent problem in the CAPM approach to estimating the cost of equity is the assumption that the average beta of their respective water utility sample groups is the beta for GCSC's. However, neither Staff nor RUCO witness's presented any evidence or data suggesting that GCSC, if it were publicly traded, would have a beta equal to that of their sample group. They have made no attempt to

analyze the particular risks (except financial risk) associated with an investment in GCSC or to compare those risks with the publicly traded water utilities in their sample groups. Instead, both simply assumed that all water utilities, regardless of a particular water utility's size and other firm-specific characteristics, have the same beta. While Staff uses 100% equity capital structure as does the Company, Staff makes a 100 basis point reduction to their cost of equity for financial risk. Staff's financial risk adjustment is flawed in that it relies on an assumed beta for GCSC. RUCO on the other hand proposes a hypothetical capital structure consisting of 40% debt. Despite lower financial risk, GCSC is more risky than the large publicly traded water utilities. The Company's unique risks, which would most certainly be considered by investors and require a higher return, include GCSC's small size, limited growth, lack of diversification, liquidity risk, and construction risk.

GCSC is more risky than the large publicly traded water utilities and possesses several unique risks that would cause an investor to require a higher return including GCSC's small size, limited growth, and lack of diversification. Neither Staff nor RUCO have provided any evidence to suggest GCSC has the same risk as their respective water utilities sample companies and should be authorized the returns suggested by their cost of capital analysis for larger publicly traded water utilities.

## **V. RATE DESIGN**

Staff and RUCO propose the same rate design as the Company. Like the Company, Staff and RUCO apply their respective recommended rate increase equally across all classes of customers to produce their respective revenue requirements.

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